

## Management Responsibilities Related to Litigation, Claims, and Assessments

### I. Management Representation Letters

A management representation letter provides the auditors with information on the status of an entity's operations. One of the assertions made by management regards the existence, or non-existence, of situations or events which could lead to future claims against the entity. It is management's responsibility to make this assertion because legal counsel cannot be expected to be aware of these contingent liabilities until they have been filed. To support this assertion, an entity's management must communicate with those program officials who would have knowledge of operations and situations from which unasserted claims could arise. It is these program officials that should be in contact with management and counsel, whether bureau staff or OGC, to determine whether an unasserted claim should be recorded. **See Attachment F, Exhibit 1**, for additional **A**Guidance on the Management Representation Letter Process relating to contingent liabilities. Please review the exhibit to ensure that your management representation letter assertions, especially in the area of unasserted claims, will be well documented.

### II. Legal Representation Letters

Management is responsible for issuing a legal inquiry letter to its counsel, from which counsel will prepare a legal representation letter for the auditors. The entity's auditors will annually instruct management to prepare this inquiry letter. **Attachment F, Exhibit 2**, lists the items which should be requested of counsel in its legal representation letter. One of the items requested is a listing of threatened and pending litigation. This listing is to include only those cases which (1) exceed an auditor-provided materiality threshold, and (2) meet the criteria for recognition of a contingent liability. Counsel is required under FASAB Interpretation No. 2, *Accounting for Treasury Judgment Fund Transactions*, to evaluate claims referred to the Department of Justice as well. Please ensure that Judgment Fund cases which meet the recognition criteria are recorded and reported in the financial statements with other contingent liabilities. **Attachment F, Exhibit 3**, is a template which **must** be used for your entity's legal inquiry letter to counsel. One version is to be used when reporting unasserted claims and the other when no unasserted claims are being reported.

## **Guidance on the Management Representation Letter Process**

Statement on Auditing Standards (SAS) No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, states that management is responsible for adopting policies and procedures to identify, evaluate, and account for litigation, claims, and assessments as a basis for the preparation of financial statements in conformity with generally accepted accounting principles.® Within the Department of Commerce, legal counsel will provide an evaluation of threatened and pending litigation, as part of a legal representation letter. Your evaluation of unasserted claims, based on the guidance below, should be furnished to your auditors as part of your management representation letter. Your response should be based on a sample letter provided to you by your auditors.

### Unasserted Claims

SAS 19 also requires a statement from management that it has disclosed all material unasserted claims which your legal counsel has advised are probable of assertion and must be disclosed in accordance with SFFAS 5. It is management's responsibility to bring unasserted claims to the attention of legal counsel. Where counsel has devoted substantial attention to an unasserted claim and has reached a conclusion that management must at least consider disclosure, counsel has the responsibility to advise management and consult with them on whether disclosure should be made. Unasserted claims should not be disclosed unless it is considered probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable. For each unasserted claim listed on the management representation letter, if any, you should report the likelihood of the outcome, and either an estimate of the amount of the loss or a comment that an estimate cannot be determined.

### Statement of Federal Financial Accounting Standards No. 5

To determine whether any contingent liability should be accrued or disclosed on the financial statements, and therefore included in the management representation letter, SFFAS 5 requires consideration of the following factors, among others:

- a. A past event or exchange transaction has occurred;
- b. A future outflow or other sacrifice of resources is at least reasonably possible; and
- c. The future outflow or sacrifice of resources is measurable.

SFFAS 5 uses the terms ~~A~~probable, reasonably possible, remote®to indicate the likelihood of an unfavorable outcome, defined as follows:

- a. *Probable.* The future confirming event or events (leading to an unfavorable outcome) is likely to occur (in cases of pending or potential litigation). The future confirming event or events is more likely than not to occur (for other types of contingencies).
- b. *Reasonably possible.* The chance of the future confirming event or events occurring is more than remote but less than probable.
- c. *Remote.* The chance of the future event or events occurring is slight.

What Should be Included in the Management Representation Letter

Based on the SFFAS 5 criteria above, unasserted claims should be listed on your management representation letter if:

- ! An unfavorable outcome is probable, and the amount of the loss can be reasonably estimated. (These items will be accrued on the financial statements);
- ! An unfavorable outcome is reasonably possible, and the loss can be reasonably estimated; or
- ! An unfavorable outcome is probable, and the amount of the loss cannot be reasonably estimated. (These two items will be disclosed on the financial statements)

Your administrative and program management officials should be working with the appropriate counsel on possible claims as they arise during the year. But management has the final responsibility to determine and present unasserted claims in its representation letter. If there are no items to report, your letter should clearly say so.

To further support the audit process, the names and phone numbers of those involved in developing the material related to litigation should be forwarded to your finance office. In previous audits, finance personnel have not always known to whom they should refer the auditors for questions on claims. Also, to meet the responsibility to account for all litigation, we recommend that you develop some method of tracking existing and possible claims, such as a spreadsheet or database. This will support the assertion that the review of claims was complete. It will also enable a quick response to the auditors or any other inquiry on the status of claims.

### **Management Responsibilities for Legal Inquiry Letters**

In addition to the management representation letter, your management will be asked, on behalf of your auditors, to send a letter of inquiry to your legal counsel. This inquiry letter is meant to corroborate the information provided by management. An inquiry letter should be sent to each source of legal counsel (i.e., lawyer or office) which has provided legal representation. The letter to the Department's Office of General Counsel should be sent to the Assistant General Counsel for Finance and Litigation. Statement on Auditing Standards No. 12 requires the following items to be included in the inquiry letter:

- a. The name of the reporting entity (bureau or fund) and the date of the audit.
- b. A request by management that the lawyer prepare a list describing and evaluating pending or threatened litigation, claims, and assessments. This list will be limited to those items to which each lawyer has devoted substantive attention on behalf of the entity in the form of legal consultation or representation.
- c. For the items in b. above, a request that the lawyer furnish the following information or comment on those matters where his/her views may differ from those stated by management, as appropriate:
  - (1) A description of the nature of the matter, the progress of the case to date, and the action the bureau intends to take.
  - (2) An evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.
  - (3) With respect to a list prepared by management, an identification of the omission of any pending or threatened litigation, claims, and assessments or a statement that the list of such matters is incomplete.
- d. The list prepared by management that describes and evaluates unasserted claims and assessments, if any, that your management considers to be probable of assertion, and that, if asserted, would have at least a reasonable possibility of an unfavorable outcome. Again, this list should be limited to those matters in which the lawyer has been engaged and to which he/she has devoted substantive attention on behalf of the bureau in the form of legal consultation or representation.
- e. For the items in d. above, a request that the lawyer comment on those matters where his/her views concerning the description or evaluation of the matter may differ from those stated by management.
- f. A statement by your management that it understands that whenever, in the course of performing legal services for the bureau with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, the lawyer has formed a professional conclusion that the client should disclose or consider disclosure concerning such possible claim or assessment, the lawyer, as a matter of professional responsibility to the client, will so advise your management and will consult with it concerning the question of such disclosure and the applicable requirements of Statement of Federal Financial Accounting Standards No. 5.
- g. A request that the lawyer confirm whether the understanding in f. above is correct.
- h. A request that the lawyer specifically identify the nature of and reasons for any limitation on his/her response.

[Date]

MEMORANDUM FOR: General Counsel

FROM: Appropriate Bureau Official

SUBJECT: Audit for the Fiscal Year Ending September 30, 199X

In connection with the audit by the firm of **X, Y & Z** of our financial statements as of September 30, 199X, and for the fiscal year ending, we request that you furnish to **X, Y & Z** *[address]* the information requested below concerning certain contingencies involving matters with which your office has been engaged and devoted substantive attention on behalf of the **[bureau]** in the form of legal consultation or representation, which should include claims to be paid by the Treasury Judgment Fund. *See Federal Accounting Standards Advisory Board's Interpretation No. 2, Accounting for Treasury Judgment Fund Transactions.* This request is limited to contingencies which exceed **[establish materiality limit]** and they therefore should be considered in connection with our audit.

Pending and Threatened Litigation, Claims and Assessments.

Please furnish to **X, Y & Z** a description of all pending and threatened litigation, claims and assessments against the **[bureau]** with which your office has been engaged and devoted substantive attention in the form of legal consultation or representation, as required by Statement of Federal Financial Accounting Standards No. 5. Your response should include; (1) the nature of the litigation, claim or assessment, (2) the progress of the case to date, (3) the bureau's response or its intentions as to its response (for example, to contest the case vigorously or to seek an out-of-court settlement), (4) an evaluation, if one can be made, of the probability of a unfavorable outcome, and (5) an estimate, if one can be made, of the amount or range of potential loss. If no such matters exist, please so indicate.

Unasserted Claims and Assessments

We have advised **X, Y & Z** that there are no unasserted possible claims or assessments which as of the date of this memorandum in the opinion of **[bureau]** management are probable of assertion and must be disclosed in accordance with Statement of Financial Accounting Standards No. 5.

We understand that, whenever in the course of performing legal services for the **[bureau]** with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, if you have formed a professional conclusion that the **[bureau]** should disclose or consider disclosure concerning such possible claim or assessment, as a matter of professional responsibility to the **[bureau]**, your office will so advise the **[bureau]** and will consult with the **[bureau]** concerning the question of disclosure and the applicable requirements of Statement of Federal Financial Accounting Standards No. 5. Please specifically confirm to our auditors that our understanding is correct.

Your response should include matters that existed at September 30, 199X, and for the period from that date to the date of your response. Your response should be dated **[date of the end of audit field work]**. Please specifically identify the nature of and reasons for any limitation on your response.

Your response will not be published, quoted or referred to in our financial statements or related documents without your prior consent.

Very truly yours,

[Date]

MEMORANDUM FOR: General Counsel

FROM: Appropriate Bureau Official

SUBJECT: Audit for the Fiscal Year Ending September 30, 199X

In connection with the audit by the firm of **X, Y & Z** of our financial statements as of September 30, 199X, and for the fiscal year ending, we request that you furnish to **X, Y & Z** *[address]* the information requested below concerning certain contingencies involving matters with which your office has been engaged and devoted substantive attention on behalf of the **[bureau]** in the form of legal consultation or representation, which should include claims to be paid by the Treasury Judgment Fund. *See Federal Accounting Standards Advisory Board's Interpretation No. 2, Accounting for Treasury Judgment Fund Transactions.* This request is limited to contingencies which exceed **[establish materiality limit]** and they therefore should be considered in connection with our audit.

Pending and Threatened Litigation, Claims and Assessments.

Please furnish to **X, Y & Z** a description of all pending and threatened litigation, claims and assessments against the **[bureau]** with which your office has been engaged and devoted substantive attention in the form of legal consultation or representation, as required by Statement of Federal Financial Accounting Standards No. 5. Your response should include; (1) the nature of the litigation, claim or assessment, (2) the progress of the case to date, (3) the bureau's response or its intentions as to its response (for example, to contest the case vigorously or to seek an out-of-court settlement), (4) an evaluation, if one can be made, of the probability of a unfavorable outcome, and (5) an estimate, if one can be made, of the amount or range of potential loss. If no such matters exist, please so indicate.

Unasserted Claims and Assessments

Since October 1, 199Y your office has devoted substantive attention in the form of legal consultation or representation to the following unasserted possible claims or assessments against the **[bureau]** which, as of the date of this memorandum in the opinion of **[bureau]** management are probable of assertion, and, if asserted, would have a reasonable possibility of an unfavorable outcome.

*[Description of unasserted claims, together with how management intends to respond and an evaluation of the likelihood of an unfavorable outcome or estimate, if one can be made, of the amount or range of potential loss.]*

Attachment F, Exhibit 3  
Unasserted Claims Listed

Please furnish **X, Y & Z** an explanation if any, that you consider necessary to supplement the foregoing information, including an explanation of those matters as to which your views differ from the views of management set forth above.

We understand that, whenever in the course of performing legal services for the **[bureau]** with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, if you have formed a professional conclusion that the **[bureau]** should disclose or consider disclosure concerning such possible claim or assessment, as a matter of professional responsibility to the **[bureau]**, your office will so advise the **[bureau]** and will consult with the **[bureau]** concerning the question of disclosure and the applicable requirements of Statement of Federal Financial Accounting Standards No. 5. Please specifically confirm to our auditors that our understanding is correct.

Your response should include matters that existed at September 30, 199X, and for the period from that date to the date of your response. Your response should be dated **[date of the end of audit field work]**. Please specifically identify the nature of and reasons for any limitation on your response.

Your response will not be published, quoted or referred to in our financial statements or related documents without your prior consent.

Very truly yours,